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RUEHLO/AMEMBASSY LONDON 9006
RUEHKP/AMCONSUL KARACHI 0545
RUEHLH/AMCONSUL LAHORE 6279
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SUBJECT: BANKS REQUIRED TO HOLD FEWER RESERVES

Summary

¶1. (SBU) The State Bank of Pakistan (SBP) reduced the cash reserve requirement of banks in Pakistan by 100 basis points to 5 percent, a 4 percent drop in the last three weeks. The reduction in cash reserve requirement and statutory liquidity requirement carried out earlier combined have generated the additional liquidity of Rs.270 billion (USD 3.3 billion at 81.05 Rupees per dollar) in the inter-bank market. The SBP has also changed the definition of "loans advanced" by banks to exclude export refinance and power sector loans. Citibank sources estimate this measure will add Rs.200 to 250 billion (USD 2.5 billion to 3.1 billion) in additional liquidity. The SBP has been taking these measures to deal with the liquidity shortages in the inter-bank market, which according the SBP Governor are partly due to excessive government borrowing from the central bank. The Governor also said that Pakistan's economic ailments originated from large fiscal and external deficits, which in turn are partly due to high commodity prices. Soaring inflation is eroding the competitiveness of industry and the purchasing power of masses. End Summary.

CASH RESERVE REQUIREMENT REDUCED. . .AGAIN

¶2. (SBU) The State Bank of Pakistan further reduced the Cash Reserves Requirement (CRR) by 100 basis points to 5 percent on November 1. The CRR has come down from 9 percent to 5 percent in the last three weeks. Every one percent reduction in CRR generates an estimated Rs 30 billion (USD 270 million) additional liquidity in the inter bank market. The SBP also instructed banks that time deposits will not require any cash reserve. The combined impact of reductions in CRR and exempting the time deposits of 1 year tenor will generate Rs.270 billion (USD 3.3 billion) in additional liquidity. The SBP has also changed the loans definition to exclude export refinance, loans to the power sector, and textiles and apparel sectors, which has reduced the Advance Deposit Ratio (ADR) from 75 to 57 percent. According to Citibank sources this change in policy will add an estimated Rs.200 to Rs.250 billion (USD 2.5 billion to 3.1 billion) to the inter bank market.

¶3. (SBU) The SBP Governor, Dr. Shamshad Akhtar, announced the policy change at the launch of Saudi-owned Samba Bank in Karachi on November 1. (Comment: Two other Saudi-owned banks already have branches in Karachi or Islamabad) Banks were facing liquidity shortages for the last two months, which caused the overnight rates to peak at 40 percent in the inter-bank market. Akhtar said that the stress on liquidity stemmed from high public sector borrowing from the banking system, withdrawal of government deposits, seasonal

cash withdrawals for Eid (Eid is a holiday that marks the end of Ramadan and fell in September), low growth in deposits, and precautionary withdrawals. Steadily, public confidence is being restored and banks are regaining lost deposits.

FISCAL DEFICIT AND COMMODITY PRICES FEED INFLATION

14. (SBU) Akhtar said that the burden of fiscal expansion was clearly unsustainable and the level of stress of the current macroeconomic burden can be judged by the growing recourse to the central bank financing of the budget, the visibly sharp decline in foreign exchange reserves and the depreciation in the rupee. The Federal Board of Revenue (FBR) collected Rs 349.8 billion in tax revenue during July-October 2008-09 versus target of Rs 329.3 billion and against Rs. 271 billion collected in the same period of last fiscal year. The tax revenue is up by 29 percent in the first four months of the current fiscal year compared to the same period last year, exceeding the target by 6.2 percent.

15. (SBU) Pakistan, being an open and highly import-dependent economy, has been hit by the surge in global commodity prices. High commodity prices exacerbated Pakistan's economic ailments through sharp growth in the domestic fiscal deficit (due to subsidies) and the external deficit. According to Akhtar, the FY08 oil import bill was equivalent to 6.9 percent of GDP or almost 80 percent of the external current account deficit. During FY08, the average price per barrel was USD 94.4 while in the first quarter of FY09 average price reached close to USD 115.5. Unless addressed, this high inflation will hurt the future competitiveness of Pakistan economy

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and has already significantly eroded the purchasing power of the poor.

ROOM FOR IMPROVEMENT

16. (SBU) Governor Akhtar said the central bank legislation in Pakistan has some outdated provisions, which need to be appropriately amended to provide more autonomy to SBP, along with proper accountability, to pursue clearly defined goals of monetary and financial stability. Akhtar also warned that the financial sector is too bank-centric, and the outreach and growth of the Non-Bank Finance Companies (NBFCs) and the insurance sector have languished in recent years. NBFCs face direct competition from banks and are not likely to grow significantly until their funding sources and costs are streamlined. At the same time, growth in the insurance sector is weak, and private pension funds have only recently started to gather some pace.

Comment

17. (SBU) Comment. Lowering reserve requirements is an expansionary monetary policy that decreases the amount banks are required to hold to meet depositors' claims and expands the effective amount of currency in circulation. This policy will reduce upward pressure on interest rates, yet it comes at the cost of feeding the 27 percent inflation that is eroding the competitiveness of Pakistan's economy and the purchasing power of its people, while marginally weakening the historically stable banking sector of Pakistan. The Government of Pakistan must address the causes of the current liquidity crisis -- the fiscal and trade deficits -- rather than chasing the symptoms with increasingly ineffective quick fixes. End Comment.

PATTERSON